End to key interest rate hikes?

Recently, hopes of an imminent end to key interest rate hikes by central banks spread across global financial markets. This led to rising prices in the stock markets in particular. Inflation rates, which have fallen recently, are the reason for the prospect of no further increases in key interest rates.

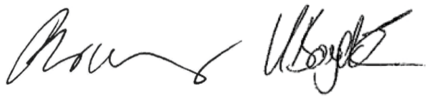
A rate of inflation of 3% was recently reported for the American economic area. Although this figure is well above the target value of 2%, it is clearly down from the figures published in previous months. Europe is facing a much more difficult situation. While Germany reported a preliminary estimate of 6.2% for July, the monetary inflation rate in Spain dropped to 1.9%. Behind these figures, we can see that there is still no sign of economic convergence between the EU countries, as was intended with the introduction of the euro in 1999. After all, inflation rates are declining in the eurozone as well. Recall that the inflation rate in October 2022 was a taut 10.2%. By now, rising interest rates are clearly having a dampening effect on economic development. The central banks are thus facing their classic dilemma, especially in the U.S. The Federal Reserve System's mandate is to ensure low inflation and full employment, while the European Central Bank is exclusively committed to price stability. For U.S. central bankers, the target-immanent conflict is eased by the demographically induced improvements in the labor market. The inverse relationship between inflation and unemployment, as postulated in the Phillips curve, has now been eased. This allows the Fed to devote itself primarily to fighting inflation. The persistence of full employment in the US also explains why the Fed has raised key interest rates much more aggressively and quickly than the European Central Bank, for example, bearing in mind that European short-term interest rates were negative for an even longer period (keyword 'custody fees'). In this respect, it seems curious and, from a German perspective, even unhistorical that the US is displaying lower currency devaluation and, at the same time, higher price stability zeal. In the days of the Deutsche Mark, when the Bundesbank still had a say, such a thing was unimaginable. Tempi passati!

However, the situation at the long end of the yield curve is far more problematic than the development of key interest rates. The yield on ten-year German government bonds is currently around 2.5%, which is 3.7% below the current rate of monetary depreciation. Although German interest rate investors are now used to high real interest rate losses, real asset growth is weak, unlike in the USA. This is also due to the traditional interest rate obsession in Germany. However, the inverted yield curve poses additional challenges for market participants. In recent years, the central banks have bought up an unimaginably large amount of government bonds on the market as part of their quantitative easing program. If central bankers wanted to normalize the interest rate market and return it to market forces, they would have to release an enormous amount of bonds onto the market. It is impossible to see who would want to buy these bonds at the yields currently offered (i.e. negative real interest rates!). In this respect, a gigantic sword of Damocles hangs over the bond market.

Market mechanisms in the stock market, however, are more dynamic. The market process of supply and demand is structurally more robust here, because there is thankfully no dominant market player, as is the case with the central banks in the bond market.

Sincerely yours,

Fund managers and co-investors



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